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SUBJECT: Argentina Economic and Financial Weekly for the week ending August 11, 2006

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Weekly Highlights
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- Argentina President Nestor Kirchner reacted negatively to possible GSP exclusion.
- Argentina and Venezuela "Southern Bond" could be issued in September.
- Argentina and Brazil plan to stop using the dollar as commercial exchange currency advances.
- GOA beef export ban has caused USD 147 million in export losses.
- The IMF publishes the article IV review of Argentina.
- Economic Minister Felisa Miceli said that inflation will be significantly lower than in 2005.
- Commentary of the Week: "There is a subtle change in monetary and exchange rate policy"

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Argentina President Nestor Kirchner reacted negatively to possible GSP exclusion.
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¶1. On August 8, Argentine President Nestor Kirchner reacted negatively to the announcement that Argentina could lose benefits from the Generalized System of Preferences (GSP) program. The GSP grants duty-free treatment to US imports of goods from developing countries, including Argentina. According to US Trade Representative Susan Schwab, the administration wants to determine whether certain countries should be excluded from the GSP program and asked for public comments on whether the benefits should be limited or withdrawn from certain countries, based on statutory criteria. Kirchner said that Argentina is an independent country that is not going to be pressured by "not too serious actions," comparing them to "old theories proper of the Roman Empire." He appears to have - as did many journalists - interpreted the GSP review as retaliation against countries that didn't support the US to reach an agreement in the Doha Round of global trade talks and to form a Free Trade Area of the Americas, and specifically against Argentina for its closer ties to Venezuela and actions at the Mar del Plata Summit in November, 2005. The Secretary of Foreign Trade, the Argentine Ambassador to the US, and the head of the Argentina Exporters Chamber all said that this review should not be interpreted as retaliation.

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Argentina and Venezuela "Southern Bond" could be issued in September.
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¶2. On August 9, Venezuela's Congressional Finance Committee approved a joint bond sale between Argentina and Venezuela. The so-called "Southern Bond" could be issued during the first two weeks of September for USD 1 billion and, according to the market response, a second tranche of USD 1 billion would be issued later. The "Southern Bond" will be a combined asset, half of it will be the Argentine Boden 2012, and the rest, a Venezuelan fixed rate bond. The first issuance will be offered in the Venezuelan market, to be sold to locals and possibly external secondary markets.

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Argentina and Brazil plan to stop using the dollar as commercial exchange currency advances.
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¶3. On August 7, during the Mercosur central bank presidents summit in Uruguay, Martin Redrado (President of the BCRA) and Henrique Meirelles (President of Brazil Central Bank) agreed to start working on a project to begin using their local currencies in bilateral commercial transactions (Argentina-Brazil bilateral trade is currently worth about USD 16.5 billion a year). As of now, each country purchases dollars to buy exports from the other partner, while in the future both countries will operate in Argentine pesos and in Brazilian reales. According to Argentine officials, the use of this procedure will not be obligatory and a joint commission will gather to start working on the project on August 14.

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GOA beef export ban has caused USD 147 million in export losses.
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¶4. According to the National Food and Animal Health Inspection Service (SENASA), Argentine beef exports were USD 480 during first half of 2006, against USD 627 in the same period in 2005 (-23 percent y-o-y). By volume, beef sales decreased 37 percent y-o-y. [On March 8, 2006, the GOA imposed a ban beef exports for 180 days and raised export taxes on boned cuts and heat-processed beef from 5 percent to 15 percent in an attempt to keep inflation under control. On May 29 the GOA eased the ban through an export quota system.]

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The IMF publishes article IV review of Argentina.
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¶5. On August 9, the IMF published its article IV review of Argentina. The IMF praised Argentina's fiscal tightening after the economic crisis, the state of the banking system and the recovery process. However, the IMF criticized the fiscal erosion during 2006, growing labor informality, price controls and the lack of measures to encourage investment. According to the IMF, price controls in Argentina are affecting the business environment and creating capacity problems in some sectors. Some of the IMF's recommendations were: for the GOA to curb the growth of primary spending, increase real interest rates to make them positive and allow for a greater upward flexibility (i.e., let the peso appreciate) of the exchange rate. The complete review can be found at http://www.imf.org/external/np/sec/pn/2006/pn 0693.htm.

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The Chamber of Deputies approves an amendment to the Consumer's Defense Law and increases the power of the Secretary of Internal Commerce.
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¶6. On August 9, the Chamber of Deputies approved an amendment to the Consumer's Defense Law that will increase the powers of the Secretary of Internal Commerce Guillermo Moreno. Under the

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amendment, Moreno will be able to impose fines of up to ARP 5 million on companies that do not comply with consumer affairs

regulations. Opposition deputies from the PRO party and businessmen criticized the amendment, arguing that the same secretary will be in charge of arranging price agreements with companies as well as applying fines to those same companies. The bill now goes to the Senate, where it is expected to be passed.

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Economic Minister Felisa Miceli said that inflation will be significantly lower than in 2005.
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¶7. On August 9, Economic Minister Felisa Miceli stated in a speech to the private sector that inflation this year is likely to be significantly lower than in 2005. Miceli also said that the GOA is committed to maintain the fiscal primary surplus of at least 3.3 percent of GDP in 2006 and to follow a similar strategy in 2007, and to keep a "competitive" exchange rate. During the same event, the Planning Minister Julio de Vido stated that the GOA is not going to change its utilities' tariff policy and that power supply during the upcoming years is assured.

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The GOA wants to keep rising rent prices down.
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¶8. After meeting with members of the real estate sector to talk about rising rent prices, the Secretary of Internal Trade Guillermo Moreno will try to reduce the cost of mortgage loans. Moreno talked to BCRA President Martin Redrado to seek an overall reduction in monthly mortgage payments and will meet with private bank directors shortly to ask them to increase the supply of mortgage loans (i.e., lower mortgage rates). According to the National Bureau of Statistics (INDEC), rents have increased 7.2 percent in 2006, while the CPI increased 4.9 percent.

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Consumer Confidence Index down 3.3 percent m-o-m.
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¶9. The consumer confidence index -- measured by Torcuato Di Tella

University -- decreased 3.3 percent m-o-m in August. All three index components decreased: consumer sentiment toward the macroeconomic environment (-3.1 percent m-o-m), consumer willingness to purchase durable goods and real estate (-7.4 percent) and improvement in personal situation (-0.2 percent m-o-m). The index has still risen 7.3 percent y-o-y. The index is based on surveys of individuals and consumer willingness to purchase durable goods, houses and cars.

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The GOA agrees to increase transportation fares.
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¶10. The GOA will gradually increase transportations fares. For medium and long distance buses, the GOA authorized an immediate 10 percent fare increase and another, close to 15 percent, on September
¶7. For domestic airfares the increase scheme is 10 percent now and an additional 10 percent on September 7. Finally, the rise for taxis will be implemented in two steps reaching a 23 percent increase by September.

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Argentina Supreme Court unlikely to readdress the "pesification" decree while vacancies remain.
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¶11. According to Argentina Supreme Court justice Carmen Argibay, until new judges are named to the Supreme Court or the Congress reduces the number of seats on the bench, it will be difficult to reach the absolute majority needed to reach a statement on the "pesification" issue. The Argentine Supreme Court currently has nine seats; at present the Supreme Court has seven judges, and positions are divided on this issue. On October 26, 2004, the Supreme Court ruled against a court injunction, validating the 2002 decree which converted dollar deposits into pesos, but that ruling was not taken as binding by the lower courts.

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Labor union leaders propose a 19 percent increase in the minimum retirement pensions.
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¶12. Labor union leaders proposed to the GOA a 19 percent increase in the minimum retirement pensions, from ARP 470 to ARP 560. Union members are organizing a demonstration for August 23 to support this request. According to union leader Hugo Moyano, President Nestor Kirchner in a private meeting committed himself to improve minimum retirement pensions before the end of 2006.

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Argentine Supreme Court ruled against selective pension increases.
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¶13. On August 8, the Argentine Supreme Court ruled against selective pension increases established by the GOA, claiming that this action infringes the National Constitution, particularly for the case of pensions above ARP 1,000 per month. According to the Court member Ricardo Lorenzetti, the issue of pension mobility should be solved in the short term, by including it in the 2007 Budget. Private consultants estimate that if the GOA applies pension mobility, the cost of this measure will be approximately ARP 5.2 billion annually, or 0.8 percent of GDP. Argentine President Nestor Kirchner asked to include this issue in the Congress 2007 Budget debates.

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The GOA announces a 180-day glass export ban.
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¶14. On August 7, the GOA announced a 180-day glass export ban, the aim of this measure is to increase local supply and avoid further increases in domestic glass prices. The GOA justified its decision by noting that there has been a "significant increase" in the domestic price of glass and an 85 percent y-o-y increase in glass exports during the January-May period.

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The BCRA consensus survey reduces its 2006 inflation forecast.
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¶15. The BCRA consensus survey reduced its 2006 inflation forecast from 11.5 percent to 10.9 percent, as expectations for prices eased after July CPI figures turned out to be lower than expected (+0.6 percent m-o-m). The BCRA consensus survey includes the forecasts of 17 banks, 19 economic consultants, 8 foundations and research centers, and 11 universities.

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Italian court rules against Banca Nazionale del Lavoro for selling Argentine bonds.
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¶16. The Tribunal of Cuneo, in north Italy, ruled against the Banca Nazionale del Lavoro bank for "irresponsible selling" of Argentine bonds to some of their clients. The Italian banks will have to pay EUR 154,250 plus interest to more than 450,000 bank clients. The Argentine public bonds under consideration are those which the GOA defaulted on during its 2002 economic crisis.

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June wage index increased 1.23 percent m-o-m -- below market expectations.
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¶17. The National Bureau of Statistics (INDEC) announced that the wage index increased 1.23 percent m-o-m in June, below market expectations of 1.40 percent, and increased 17.74 percent y-o-y. This index defines wages as a price, without considering hours worked or special payments for productivity gains. This index surveys the formal and informal private sector and the public sector, which rose 1.44 percent, 1.05 percent and 0.79 percent, respectively. The consensus survey forecasts a 16.9 percent increase in the wage index for 2006. INDEC also announced that the basic food basket -- used to measure indigence -- decreased 0.21

percent m-o-m and the total basic basket -- used to measure poverty -- increased 0.25 percent m-o-m in July.

BCRA rolls over its maturities and decreases rates for Nobacs.

¶18. The BCRA received ARP 1.9 billion in bids at its August 8 Lebac and Nobac auction, compared to ARP 1.1 billion in Lebacs that came due during the week. It accepted ARP 577 million in Lebac bids and ARP 533 million in Nobac bids. The yield on the 168-day Lebac remained at 8.50 percent and, on the longest term instrument, the 364-day Lebac, the yield was 11.90 percent. Lebacs with a maturity of 252-day were withdrawn because of the BCRA's decision to not accept the yield proposed by the market, and Lebacs for maturities of more than 364 days were withdrawn due to lack of interest. The spread on the one-year Nobac decreased from 2.03 percent to 1.57 percent and the two-year Nobac from 3.72 percent to 3.43 percent. The Badlar rate (the base rate for Nobacs) is currently at 9.6 percent. Accepting almost all Lebac bids and rejecting more than half of Nobac bids seems to be a new BCRA policy, beginning last week.

The peso is unchanged against the USD this week, closing at 3.09 ARP/USD.

¶19. The peso remained flat versus the USD this week, closing at 3.09 ARP/USD. The BCRA is not reporting daily transactions in the dollar market. The peso exchange rate has depreciated 1.3 percent since the beginning of the calendar year. The BCRA's reserves stood at USD 27.1 billion as of August 9, and have increased USD 8.5 billion, or 46 percent, since the GOA prepaid its entire IMF debt on January 2.

Commentary of the Week: "There is a subtle change in monetary and exchange rate policy", by Miguel Kiguel, from an article published in El Cronista Comercial on July 24.

¶20. The exchange rate in Argentina has remained stable in recent months, while interest rates have been increasing very gradually and the Central Bank continues carrying out its monetary program and its objective of accumulating reserves. Is something changing with respect to monetary policy? What can be expected in the coming months?

¶21. At first it would seem the Central Bank has changed its exchange policy. To the surprise of many, the Central Bank of Argentina has not allowed the exchange rate to surpass ARP 3.10/dollar during the period of financial turbulence, and on at least five occasions it sold dollars on the market to avoid a depreciation of the peso.

¶22. This change appears to be a side effect of price controls, given that in the current context an increase in the exchange rate could motivate businesses to request price readjustments in areas subject to agreements. If this interpretation is correct, we would expect an adjustment in exchange rate policy from now on, where not only is the impact of the peso's depreciation on the level of competitiveness evaluated, but also its effect on prices.

¶23. This change could also complicate the Central Bank's ability to accumulate reserves though currency market intervention. This means that a greater part of foreign currency purchases would have to be paid through a fiscal surplus or government debt. A possible alternative, which I imagine no one is considering, would be to limit controls on the inflows of capital.

¶24. It would also appear that the Central Bank is adjusting its monetary policy, although it continues carrying out to the letter the M2 policy targets set for this year. But to be able to continue meeting its goals for all of 2006, it will be necessary to slow down the growth of monetary aggregates in the second half of the year,

coinciding with the period in which demand for money increases for seasonal reasons.

¶25. In fact, the Central Bank is slowly increasing interest rates of reverse repos since the beginning of the year, and one-year Lebac rates are already at a rate of 12 percent annually. Short-term interest rates in the inter-bank market also reflect the new financial situation, given that they are fluctuating around 8 percent and wholesale fixed-term rates are already at 9 percent, almost twice what they were at the beginning of 2005.

¶26. The new measures taken by the Central Bank - where reserve requirements for sight accounts rose by two percentage points and fell for CD deposits of more than six months, and where the inclusion of cash in banks to meet the reserve requirements is limited -- will have a significant contractionary effect. This will surely affect the growth of monetary aggregates, especially transaction aggregates, with the objective of ensuring the monetary program is met.

¶27. It is also true that the new measures are expected to raise interest rates because they will reduce liquidity in the banking system. What is becoming clearer is that the monetary goals, although they were fairly loose for 2006, are beginning to function as a limiting element in the handling of monetary policy and unlike in previous years, could bring about tensions between different monetary objectives

¶28. Without a doubt, fixing the monetary target on M2 instead of on the monetary base has been a significant step in the right direction. In fact, meeting the monetary base goal in 2005 was, in a way, less complex, given that it didn't require depending on market instruments like interest rates as much as this year, and that it could be managed through changes in reserve requirements and with the greater use of reverse repos and Lebacs.

¶29. Everything indicates that we are beginning to see a subtle but significant change in monetary and exchange rate policy, which appear to head in the right direction. We also anticipate that the Central Bank will fulfill its monetary program for 2006, although it will mean a smaller excess of liquidity in the banking system and new increases in short-term interest rates. On the other hand, the exchange policy certainly will not change in any significant way in the coming months.

¶30. The Central Bank's next challenge will be the 2007 monetary program, which will likely fix new M2 goals. Although this time, if

it continues to maintain its gradual policy, it will be with a ceiling under 20 percent. (Note: We reproduce selected articles by local experts for the benefit of our readers. The opinions expressed are those of the authors, not of the Embassy. End Note.)

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